

GAO

Report to the Honorable John D.  
Dingell, Ranking Minority Member,  
Committee on Energy and Commerce,  
House of Representatives

August 2001

# INSURANCE REGULATION

The NAIC  
Accreditation Program  
Can Be Improved

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United States General Accounting Office  
Washington, DC 20548

August 31, 2001

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Energy and Commerce  
House of Representatives

Dear Mr. Dingell:

As you requested, this report provides information about the National Association of Insurance Commissioners' (NAIC) voluntary accreditation program for state regulation of insurers' solvency. NAIC evaluates a state's regulatory program about once every 5 years to determine if it meets the association's minimum standards for effective solvency regulation. The accreditation program has now been in place for about 10 years. During that period, NAIC has expanded the standards and modified the process for evaluating the adequacy of states' solvency regulation. As discussed in our report of September 2000, weaknesses in solvency regulation in Tennessee and Mississippi and three other states allowed a \$200 million insurance fraud, allegedly masterminded by Martin Frankel, to continue for 8 years, resulting in the failure of seven insurance companies.<sup>1</sup> The fraud was uncovered and made public in May 1999. During 2000 both Tennessee and Mississippi underwent accreditation reviews by NAIC and were reaccredited. As agreed with your office, the objectives of this report are to (1) discuss NAIC's ongoing efforts to improve the accreditation program, and (2) analyze the NAIC's accreditation reviews in Tennessee and Mississippi after the fraud was uncovered and identify actions NAIC can take to strengthen its accreditation of state insurer solvency regulation.

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## Results in Brief

NAIC's voluntary accreditation program has existed now for more than 10 years. During this time, the program has demonstrated its value by defining a common set of basic regulatory requirements for solvency regulation and successfully engineering their adoption by nearly all states.

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<sup>1</sup>See *Insurance Regulation: Scandal Highlights Need for Strengthened Regulatory Oversight* (GAO/GGD-00-198, Sept. 19, 2000).

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Currently, 47 state insurance departments and the District of Columbia are accredited through NAIC. In the years since its inception, NAIC has moved to improve and strengthen its accreditation program by adding model laws and regulations to the required standards in order to address the changing environment of the insurance industry and insurance regulation. In addition, it has revised the way accreditation reviews are performed and scored and has improved training for members of review teams.

However, our analysis of the accreditation reviews done in Tennessee and Mississippi (the principal regulators of several insurance companies that failed because of the scam allegedly perpetrated by Martin Frankel) disclosed gaps and weaknesses in the accreditation program. First, we found that the program does not cover a key area of solvency regulation—chartering and change in ownership of insurance companies. Oversight of chartering and changes in ownership is key to preventing inappropriate and undesirable individuals from gaining control of insurance companies. The insurance fraud exposed weaknesses in state regulation and oversight in this area that are not addressed in NAIC's accreditation program. Second, we found weaknesses in on-site accreditation review procedures. These weaknesses included incomplete analyses of exam information, a questionable scoring methodology that can give misleading results, limited on-site compliance testing, and insufficient flexibility in tailoring reviews to address the most material issues. While we identified these weaknesses during our review of the reaccreditations in Tennessee and Mississippi, it is likely that similar issues would arise in other reviews, as NAIC officials report that the reaccreditation reviews done in Tennessee and Mississippi conformed to the accreditation processes and practices routinely followed by NAIC in the reaccreditation of all other states.

To further improve the voluntary state accreditation program and to address weaknesses that raise questions about the credibility of NAIC's accreditation reviews, this report recommends that NAIC take several actions. First, we recommend that NAIC expand the accreditation standards by developing or amending the necessary model laws, regulations, and accreditation review guidelines to ensure effective oversight of chartering and change in ownership. We also recommend that NAIC implement on-site review team procedures that require the inclusion of all relevant examination information and the use of a scoring methodology that emphasizes those standards with the most direct impact on insurer solvency. Finally, we recommend that NAIC make the accreditation process more flexible—allowing the review team to focus on the areas of greatest risk by extending visits when appropriate and targeting the most material issues through expanded testing. NAIC

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generally agreed to consider each of these recommendations. Their comments are discussed near the end of this report.

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## Background

Insurance companies are regulated principally by the states and are chartered under the laws of a single state, known as the state of domicile. Companies may conduct business in multiple states, but the state of domicile remains the primary regulator. States in which an insurer is licensed to operate but is not chartered typically rely heavily on the company's primary regulator in its state of domicile to oversee the insurer.

NAIC is a voluntary association of the heads of insurance departments from each state, the District of Columbia, and four U.S. territories. State insurance commissioners created NAIC in part to help address the problems that arise when state insurance regulators try to oversee insurers that operate in a number of states, each with its own regulatory authority and laws. NAIC provides a national forum for addressing and resolving major insurance issues and for promoting the development of consistent policies among the states. It also serves as an information clearinghouse and provides a structure for interstate cooperation in examining multistate insurers. In addition, NAIC develops and distributes model insurance laws and regulations for consideration by member states and reviews the regulatory activities of state insurance departments as part of its national accreditation program.

The need for a national accreditation program was recognized during the 1980s to early 1990s when many insurance companies became insolvent (between 1986 and 1992, there were 276 insurance company insolvencies). The severity of the problem focused attention not only on state regulators' ability to address solvency issues, but also on the lack of uniformity in solvency regulation at the state level. In June 1990, NAIC established its voluntary accreditation program to improve state oversight of insurers' solvency.<sup>2</sup> The program's overall goal is to achieve a consistent, state-based system of solvency regulation throughout the country. The specific objectives of the accreditation program are to identify the basic authorities needed for solvency regulation at the state level and thereby to provide baseline requirements for effectively regulating the solvency of multistate insurers.

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<sup>2</sup>A detailed description of the NAIC accreditation program can be found in appendix II, together with the standards that states must comply with in order to be accredited.

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NAIC's accreditation program emphasizes adequate solvency laws and regulations, efficient and effective financial analysis, examination processes and communication, and appropriate organizational and personnel practices. According to NAIC's description of the accreditation program, the standards are grouped under three objectives. Part A covers laws and regulations, Part B deals with regulatory practices and procedures, and part C includes organizational and personnel practices.<sup>3</sup> To meet the requirements of Part A, state insurance departments must have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs. Essentially, state legislatures need to have adopted NAIC's 18 suggested model laws or substantially similar versions and authorized the state insurance regulators to implement appropriate regulation. The Part B compliance standards are designed to assess whether a state seeking accreditation has "effective and efficient financial analysis and examination processes." In order for the state insurance department to satisfy the 19 Part B standards, a state must demonstrate the necessary capabilities and practices to conduct financial analyses and examinations, to communicate with other states, and to develop and implement procedures for troubled companies. Part C has three standards designed to ensure that state insurance departments have appropriate organizational and personnel practices that encourage professional development, establish minimum educational and experience requirements, and allow the departments to attract and retain qualified personnel.

To receive NAIC accreditation, state insurance departments must satisfy these minimum standards. To be accredited initially, a state must undergo an on-site accreditation review. To maintain accredited status, states must undergo interim annual reviews (off-site evaluations by NAIC staff) and full on-site reviews every 5 years. As of August 2001, most accredited states had completed their second on-site accreditation review, and some states have already completed their third. Evaluating the state's oversight of insurer's financial condition is the major focus of the on-site reviews.

Since the accreditation program is focused solely on solvency regulation, it does not evaluate other aspects of an insurance department's regulatory responsibility and oversight. For example, market conduct is one important area of regulatory responsibility that accreditation does not

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<sup>3</sup>*Financial Regulation Standards and Accreditation Program*, June 2001, p. 2.

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address. Market conduct includes all issues related to the sale of insurance products to consumers of insurance.

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## Oversight Activities of State Insurance Regulators

The oversight activities of state insurance regulators may differ, but each regulator is to oversee several safety and solvency functions through key phases of oversight activities, including chartering and change in ownership approvals,<sup>4</sup> routine financial analyses, and periodic on-site examinations. Before approving a new charter or change of ownership, regulators are to review the background and qualifications of individuals making the request. The application must be made in the domiciliary state. Subsequently, an insurer may also apply for a license in other states where it intends to sell insurance.

In general, once a domiciliary state has approved an ownership application, that state continues to oversee the insurer through routine financial analyses and reviewing annual and quarterly reports and supplemental filings submitted by the insurance companies. These reports contain information such as financial statements, responses to questions about company activities, and schedules summarizing investment and other business activity. NAIC assists these review efforts with financial analysis tools such as Insurance Regulatory Information System (IRIS) and Financial Analysis Solvency Tracking (FAST) ratios.<sup>5</sup> These tools help state insurance analysts identify areas of potential regulatory concern, particularly indicators that could suggest financial difficulties.

NAIC also issues guidance to assist regulators in performing financial analyses and examinations. For example, NAIC's *Financial Analysis Handbook* is designed to help states identify troubled insurance companies as early as possible. The handbook includes checklists on financial concepts and analyses deemed important for assessing the

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<sup>4</sup>Regulators generally require applicants to follow the same process both for chartering a new insurance company and for purchasing an existing one. The companies that Mr. Frankel allegedly acquired had all been previously owned and operated by others before Frankel-controlled entities purchased them.

<sup>5</sup>Nearly all insurers, except for the smallest ones, submit their annual and quarterly reports to NAIC as well as to their domiciliary regulator. States where the companies are licensed also receive copies of the reports. NAIC then calculates a number of financial ratios, known as the IRIS and FAST ratios, performs some preliminary analyses, and returns the information to the domiciliary state. NAIC flags ratios that are outside the "usual range" for additional regulatory attention.

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company's financial condition. The NAIC's *Financial Condition Examiner's Handbook* is another tool NAIC has developed to assist state regulators in detecting as early as possible insurers experiencing financial trouble or engaging in unlawful and improper activities and to develop the information needed for timely, appropriate action.

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**Key States Affected by Insurance Fraud Subsequently Receive Reaccreditation**

In September 2000, we reported on a \$200 million fraud that resulted in insurance company failures in six states. Four of the failed insurance companies were domiciled in Tennessee and Mississippi.<sup>6</sup> Both Tennessee and Mississippi received their initial accreditation in 1994.<sup>7</sup> The fraud was subsequently discovered in May 1999. In the aftermath of the failures, the Tennessee Bureau of Insurance did not control certain documents related to the failed insurance company that were being reviewed by other Tennessee officials. As a result, Tennessee's second-round accreditation review was delayed until February 2000. NAIC suspended the state's accreditation in March 2000. However, Tennessee's accreditation was reinstated in September 2000 after another on-site review. Mississippi's second round accreditation was awarded in December 2000, about one year after the five-year anniversary date of its initial accreditation.<sup>8</sup>

Both the Tennessee and Mississippi second-round accreditations occurred in an environment of long-standing insurance solvency oversight weaknesses that had been uncovered by the discovery of the \$200 million insurance fraud (fig.1). Each company that ultimately failed because of the fraud had been looted of its assets shortly after the company's purchase by Thunor Trust, the entity allegedly controlled by Martin Frankel. The investment fraud scheme then continued, in some cases for years, until the fraud became public in May 1998. Appendix I describes the details of the fraud allegedly perpetrated by Mr. Frankel.

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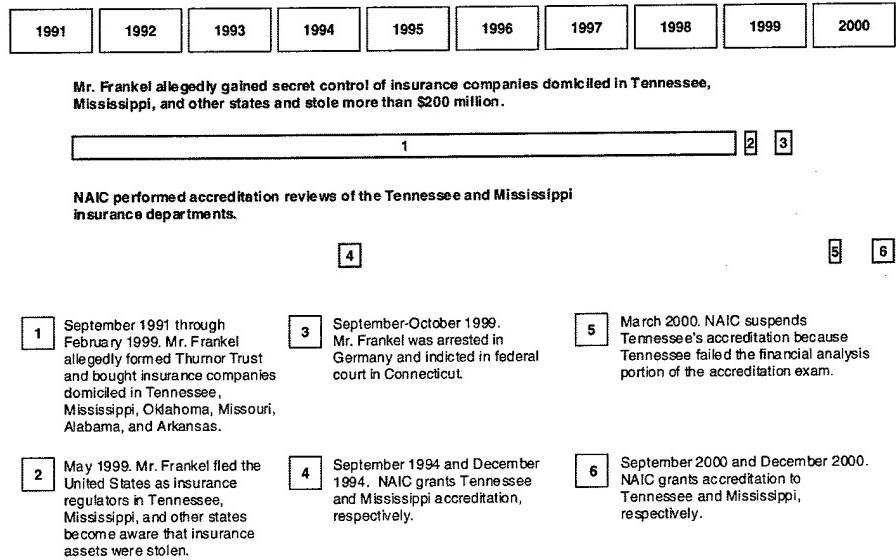
<sup>6</sup>Fraud occurs in all types of financial institutions and its detection is an important responsibility of all regulators. However, detection of fraud can be difficult because perpetrators often falsify records, lie under oath, and use other deceptions to avoid discovery.

<sup>7</sup>At the time of Mississippi's first-round accreditation, only one of the three Mississippi insurance companies allegedly purchased by Martin Frankel was under his control.

<sup>8</sup>NAIC officials told us that the Mississippi second-round accreditation review was not deferred because of events associated with the fraud. The Mississippi review, along with the reviews of four other states, was deferred at NAIC's request because of the review teams' workload.

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**Figure 1: Comparison of the Dates of Accreditation Reviews in Tennessee and Mississippi With the Term of the Fraud in Those and Other States**



Source: NAIC documents and GAO analysis.

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## NAIC's Accreditation Program Has Improved Over Time, Helping States Strengthen Solvency Regulation

Prior to the inception of the NAIC accreditation program, solvency regulation varied widely across the states.<sup>9</sup> NAIC had developed numerous model laws and regulations, but adoption by the states was inconsistent. NAIC instituted the accreditation program in order to improve the quality and consistency of solvency regulation across the states. The program has demonstrated its value by defining a broadly accepted set of basic regulatory requirements for solvency regulation and successfully engineering their adoption in nearly all states. Currently, 47 state insurance departments and the District of Columbia are accredited—a level of consistency far superior to what existed before the program. The number of insurance company insolvencies in 1993–2000 was 109, a substantial decrease from the 276 insolvencies reported in the previous 7-year period. Although several factors have likely contributed to this decline, one, according to NAIC officials, was a concerted effort by NAIC and state governors' offices, legislatures, and insurance departments to

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<sup>9</sup>See *Insurance Regulation: Assessment of the National Association of Insurance Commissioners*, (GAO/T-GGD , May 22, 1991).

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improve solvency regulation in the states, including the adoption of NAIC's Financial Regulation Standards and Accreditation Program.

In addition to encouraging the widespread adoption of fundamental insurance laws and regulations, the accreditation program has required state insurance departments to make other changes in order to satisfy the solvency standards. For example, NAIC officials described to us improvements in the financial analysis and examination processes used by state insurance departments that can be attributed to the accreditation program. Between 1990 and 2000, state insurance departments increased the number of financial analysts from 165 to 471. To support increased demands for training from the states, NAIC has expanded its training programs for financial analysis and examination staff from state insurance departments. In 2000, more than 1,900 insurance regulators attended the training programs. In addition, NAIC officials added a new standard to the accreditation program requiring states to adopt and follow the NAIC's *Financial Condition Examiners' Handbook* or develop a document that is substantially similar. NAIC officials said that the new standard has improved the consistency and quality of state examination procedures.<sup>10</sup>

GAO first reviewed NAIC's accreditation program about 10 years ago.<sup>11</sup> Since then, NAIC has made several improvements, some in response to GAO's recommendations and others in response to suggestions from within NAIC itself and from other outside observers. It has added model laws and regulations—for example, the standards now require insurance companies to measure and report risk-based capital, and depending on the level reported, departments must take specific corrective actions. NAIC has also added standards that reflect best practices for conducting financial analyses and examinations. For example, it has expanded the financial analysis standards to require departments to analyze each company in depth, document the financial analysis procedures, and report

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<sup>10</sup>Both the NAIC's *Financial Condition Examiners' Handbook* and *Financial Analysis Handbook* are intended to serve as advisory guides for state insurance departments. Only the *Financial Condition Examiners' Handbook* is required as part of the accreditation standards.

<sup>11</sup>*Assessment of the National Association of Insurance Commissioners* (GAO/T-GGD-91-37, May 22, 1991); *The Financial Regulation Standards and Accreditation Program of the National Association of Insurance Commissioners* (GAO/T-GGD-92-27, Apr. 9, 1992); *The National Association of Insurance Commissioner's Accreditation Program Continues to Exhibit Fundamental Problems* (GAO/T-GGD-93-26, June 9, 1993).

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and act on material adverse findings. The expanded financial examination standards require the examination staff to exchange information with other department staff. In addition, a new standard requires states to adopt the statutory authority required to share confidential information with other state insurance departments and to protect confidential information those departments provide.<sup>12</sup> Finally, NAIC has increased its reviews of insurance department files documenting actual financial analyses and examinations, changed the scoring system, and provided detailed guidance for accreditation review teams.

In the first round of accreditation reviews, the review team was responsible primarily for assessing whether each state had the laws, regulations, processes, and resources necessary to regulate solvency. With the beginning of the second round of accreditation reviews in 1996, the focus expanded to better assess how effectively a state has used the laws, regulations, processes, and resources to regulate the solvency of insurers since the last accreditation on-site review. In the original round of accreditations, the review team concentrated only on the most current state analysis and examination procedures. While current department procedures continue to be the primary focus in the second and subsequent rounds of reviews, the teams may also review department analysis and examination files for all years since the previous review. For example, when selecting a sample of insurance company analysis and examination files, NAIC now requires the review teams to select at least one company from each of the following three categories, even if they have to go back as long as 5 years to find examples:

- companies that are not financially troubled;
- companies the state has identified as financially troubled;
- companies that are insolvent and that have been subject to receivership proceedings during the last 5 years.

Although the teams may have selected companies from each of these categories in the first round of reviews, NAIC did not specifically direct them to do so.

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<sup>12</sup>The standard does not require documented evidence that such communication actually took place, only that the states have both the legal authority and a written policy allowing them to do it.

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NAIC continues to be open to improvements in the accreditation program. In our September 2000 report on the \$200 million fraud allegedly perpetrated by Martin Frankel, we identified a number of regulatory weaknesses that contributed to the failures of seven insurance companies. Although the accreditation program had minimum standards that the NAIC believed were sufficient for effective solvency regulation, the alleged Frankel scam exposed weaknesses in the accreditation program standards for financial examination, analysis, and related review guidelines, and in the standard for communication among states. Specifically, the program did not have an accreditation standard for asset custodians and lacked review team guidelines requiring the use of investment specialists. Moreover, while the program did have a standard about communication with other regulators, the standard did not require a regulator to proactively tell other interested states about a troubled insurer. Similarly, there was no standard requiring a state to obtain ownership applicant information from other states or to alert other states about possible fraud.

The insurance fraud led NAIC, as part of its overall corrective actions strategy, to propose changes to its accreditation standards and guidelines that are designed to minimize the likelihood of a similar fraud occurring again. NAIC has given these changes—one new standard and four review team guidelines—high priority and anticipates making them effective during 2002. The standard identifies requirements for asset custodians. NAIC expects to add it to the accreditation standards after adopting the model law at the 2001 Fall National Meeting. The three review team guidelines cover the use of investment expertise, more frequent examination of troubled insurers, and proactive communication by states regarding troubled insurers have been adopted and are expected to become effective in January 2002. The fourth review team guideline would require that states use a centralized database on applicants seeking to charter or buy an insurer that is currently being developed. This database is to be called the Form A database because the information will come from Form A's filed by insurers and those seeking to charter or buy an insurer. At present, specifications for the Form A database have been approved and a prototype of the database system was presented at the NAIC 2001 Summer National Meeting. The database is expected to become operational in March 2002.

Other changes to the review team guidelines have been suggested, but their prospects and time frames are less certain. These include requirements that actions associated with the Part A process be reviewed during the financial analysis and examination processes and that communication between state insurance departments and other federal

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and state regulators be improved. A proposal to revise the Preamble to the Review Team Guidelines that would require the accreditation review teams to evaluate the implementation of the Part A standards has been presented to the relevant NAIC committee. Other proposals to expand accreditation standards by requiring communication with other state and federal regulators are under consideration.

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## Accreditation Program Still Has Gaps and Weaknesses

While there have been changes and improvements in the NAIC accreditation program since its inception, our analysis of the second round of accreditation reviews for Tennessee and Mississippi disclosed shortcomings in the scope, operations, and methodology of the accreditation program (table 1). Tennessee and Mississippi were the states of domicile for four of the seven companies that were looted of their assets early in the insurance fraud allegedly perpetrated by Martin Frankel that extended over an 8-year period ending in May 1999. The long-term failure of insurance regulators to uncover the fraud and associated asset theft revealed a number of regulatory deficiencies in both states. These shortcomings were identified in our September report. NAIC officials, as well as the head of the NAIC accreditation review teams that conducted on-site accreditation reviews in Tennessee and Mississippi, knew of the investment fraud prior to the accreditation reviews. However, because of gaps and procedural weaknesses in the structure of the accreditation program, known regulatory oversight deficiencies existing in Tennessee and Mississippi had a relatively minor effect on the accreditation process and resulting decisions.

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**Table 1: Overview of Accreditation Program Weaknesses**

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<b>Accreditation program element</b>	<b>Weakness</b>	<b>Specific observation</b>
Coverage of all key aspects of solvency regulation	<ul style="list-style-type: none"><li>• Gap in “front-end” coverage involving chartering and change in ownership of insurance companies</li></ul>	<ul style="list-style-type: none"><li>• A critical area of state insurance regulation designed to prevent undesirable individuals from owning companies or engaging in questionable business strategies is not assessed.</li></ul>
Accreditation review team analysis procedures	<ul style="list-style-type: none"><li>• Incomplete analysis of prior examinations</li><li>• Use of a scoring methodology that can yield misleading results</li><li>• Reliance on limited on-site compliance testing</li><li>• Review procedures are inflexible</li></ul>	<ul style="list-style-type: none"><li>• Only the most recent exam is fully considered, rather than all relevant exams during the 5-year review period.</li><li>• Equal weighting of standards in each section of Part B allows states to obtain passing scores despite material problems that may not have been corrected<sup>a</sup></li><li>• “No basis for evaluation” scores contain a bias toward passing.</li><li>• Averaging within segments can result in passing scores despite unresolved problems.</li><li>• Review team members have only 3 days during their 4–5 day visit to perform testing, regardless of the size of the insurance department and the complexity of its workload.</li><li>• Review procedures and practices are not risk-focused. That is, they are not adjusted to focus on areas deemed most crucial, such as known material issues.</li></ul>

<sup>a</sup>Appendix II explains the standards in full.

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**The Accreditation Program Does Not Evaluate Chartering and Changes in Ownership**

The accreditation program is intended to provide baseline requirements for effective solvency protection by state insurance departments. Overseeing chartering and changes of control of insurance companies is a key element of solvency regulation. However, the accreditation program largely ignores this important aspect of oversight—the so-called front-end of solvency regulation.

None of the NAIC accreditation reviews in Tennessee and Mississippi looked at or commented on this aspect of solvency regulation. Our review of the accreditation program material and the work papers for these reviews shows why. Accreditation standards and review team guidelines focusing on a department’s performance during chartering and change in ownership do not exist. However, one Part A standard requires a state to have statutory authority for changes in the control of insurance companies; what this standard requires is substantially similar to the authority provided by the NAIC’s model Insurance Holding Company System Regulatory Act and Regulation. The Act and Regulation sets out the procedures that insurance companies must follow when requesting a

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change in control of an insurer. Moreover, according to an NAIC representative, both Tennessee and Mississippi had these statutory and administrative authorities in place at the time Martin Frankel was allegedly buying insurance companies. However, the accreditation program includes no standards for the chartering process and no Part B Standards or review team guidelines requiring evaluation of the states' performance in these areas. As a result, the existing weaknesses were ignored.

Although not fully addressed in the accreditation reviews, regulatory oversight in this area is key to preventing undesirable individuals from owning or managing insurance companies and to blocking companies from becoming involved in questionable business strategies. Both Tennessee and Mississippi had regulatory oversight processes in place for approving charters and changes in ownership for insurance companies. However, our report on the insurance fraud perpetrated in those states noted several weaknesses in regulatory performance existing during change in ownership approval activities. These weaknesses included (1) inadequate due diligence performed on buyer application data, (2) inadequate tools and procedures to validate individuals' regulatory or criminal backgrounds, and (3) lack of coordination between regulators within and outside the insurance industry.

As we noted in our earlier report, performing due diligence on buyer application data is an essential part of regulatory oversight, as the purchase of insurance companies provides a number of opportunities for regulators to ask questions about the prospective owners. This phase of insurance regulation involves determining the intentions and appropriateness of the buyer and the business strategy they intend to employ. In addition, the states' review of the data associated with an application for the change in ownership of an insurance company, documented in a format prescribed by NAIC known as a Form A, requires key information to be provided by applicants, but does not include checks on individuals' regulatory or possible criminal histories. A fundamental aspect of the investment fraud was the concealment of a secret affiliation that allegedly existed between entities in the insurance and securities industries, so that the investment entity controlling the insurers and the entity controlling their invested assets were one and the same. Had regulators in Tennessee and Mississippi (as well as the four other states having primary regulatory responsibility for companies involved in the insurance fraud) exercised a higher degree of scrutiny or professional skepticism during the Form A application process, the fraud might have unraveled at the outset.

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NAIC and state officials have acknowledged the need to include additional assessments of chartering and change of ownership in the accreditation program. However, NAIC officials told us that they don't plan to add new accreditation standards until after establishing a Form A database that can be shared by the states. A prototype of the database has been demonstrated, and it is expected to become operational in March 2002. Once this step is completed, NAIC intends to begin focusing on developing accreditation standards for front-end solvency regulation. NAIC, through its committee process, has already made progress in developing checklists and procedures for the review of Form A filings. Such checklists and procedures may further enable state insurance departments to evaluate solvency issues related to change of ownership.

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#### Analysis Procedures Contain Many Weaknesses

NAIC's descriptions of the accreditation program stress the importance to consumers of "effective solvency regulation." NAIC's guidance on the standards and the review process for the second round accreditation reviews requires review teams to evaluate the insurance department's performance in addition to determining whether the departments has the appropriate procedures in place.<sup>13</sup> Second round accreditation policy guidance from NAIC for the Part B Standards (Regulatory Practices and Procedures) states that insurance departments are to "...demonstrate to the review team that they timely identify potentially troubled insurers and institute appropriate courses of action." Regulators' failure to do so was precisely the problem in both Tennessee and Mississippi. The failure of the accreditation process to fully recognize this regulatory failure illustrates additional weaknesses that limit the effectiveness of NAIC's accreditation process. These weaknesses include the review teams' failure to adequately consider all potentially relevant examination information, the use of a biased scoring methodology, a reliance on cursory compliance testing, and a general inflexibility in review procedures that does not allow reviewers to address all material issues. As a result, accreditation reviews may not consistently focus on important regulatory weaknesses and areas of vulnerability—that is, those that heighten the risk of material losses.

#### Potentially Relevant Exam Information Is Not Adequately Considered

Accreditation review teams generally include only the most recent examination activity for the companies they sample when assessing a state for accreditation. For this reason, the analysis does not include all the

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<sup>13</sup> *NAIC Policy Statement on Financial Regulation Standards for the Second Round of Accreditation Reviews*, National Association of Insurance Commissioners, May 20, 1998.

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examinations of these companies that were completed during the current accreditation cycle. In the case of the first Tennessee reaccreditation review in February 2000, reviewers selected six companies for the review of examination files. One of these companies was the Franklin American Life Insurance Company, which failed after having been looted in the fraud allegedly perpetrated by Martin Frankel.<sup>14</sup> The theft of company assets, which occurred shortly after the company changed ownership in 1991, had been discovered in the most recent exam (between September 1998 and May 1999). Because the theft was discovered, the examination received good marks from the review team. This good score contributed to the state's high mark for the examination standard.

At the time of the reaccreditation on-site review in February 2000, Tennessee had completed three solvency examinations of Franklin American during the period of its participation in the fraud, two of them covering the full scope of the company's activities and one targeted to investment activities. The first two exams had missed the fraud and the theft of assets. Accreditation officials explained that the review team did not consider the first examination of the company because, although the examination report had been issued after the first-round review, the "as of" date of the examination was December 31, 1992, before the date of the review. The second examination, in September 1996, also missed the fraud. This examination specifically targeted Franklin American's investment activities—the precise area that was the focal point of the fraud. Accreditation officials told us that this examination was considered by the review team in its review and deliberations. However, it could not have been given much weight in the scoring. Summary notes from the review team voting session indicated that the reporting of material adverse findings by the Tennessee department was "good" (with a score of 4.2 out of 5) and action on material adverse findings was "timely" (also given a

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<sup>14</sup>Franklin American was included in the review team sample only indirectly because it was one of the companies affected by the \$200 million fraud. Second-round accreditation procedures require the sample of companies to include at least one failed company. Franklin American was Tennessee's only failed multistate insurer in the period since the last accreditation review.

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score of 4.2).<sup>15</sup> In fact, both the fraud and the fact that the assets of the company had been stolen went undetected by the department for nearly 8 years.

One possible explanation for the accreditation review team's apparent disregarding of the department's failure to identify the theft of assets from Franklin American in a timely manner may be found in the standards themselves and in the review team guidelines. While there are two standards on material adverse conditions, there is no standard for assessing the failure of examiners to find an existing material adverse condition. Even without an explicit standard, however, the review team could have considered whether a department failed to find a material adverse condition. This consideration would be included in the scoring of the standard for reporting a material adverse condition, because if the condition is not found, it can not be reported. Yet the review team guidelines do not include any direction to the team concerning this important scoring issue, and the Tennessee review team did not choose to consider the failure of Tennessee examiners to identify the fraud in a timely fashion. As a consequence, Tennessee's accreditation results did not fully reflect the department's performance during the accreditation review period.

#### Scoring Can Provide Misleading Assessments

The accreditation reviews in Tennessee and Mississippi revealed three weaknesses in the scoring methods used that, taken collectively, can dilute the role of professional judgement and cause misleading or questionable results. Part B, where the scoring weaknesses occur, is broken into three components, or subparts—financial analysis (with eight elements), financial examinations (with nine elements), and troubled companies and communication with other regulators (with two elements). (See appendix II.) The weaknesses in scoring the Part B standards include giving equal weight to each of the elements of the standards, averaging or “netting” the

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<sup>15</sup>While there is little argument that the Tennessee examination started in late 1998 was instrumental in identifying the fraud and, for the first time, uncovering the theft of company assets, it should be noted that the contract examiner reported the fraud and theft to the department in February 1999. The department did not subsequently take control of the company until after the Mississippi Department raised concerns in May 1999. By that time, an additional \$50 million had been stolen from other insurance companies, and Martin Frankel had fled the country.

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scores within each of the subparts of the Part B standards, and maintaining an inherent scoring bias toward passing.<sup>16</sup>

The scoring system assigns equal weights to all 19 elements in Part B. Thus the elements in each section are treated equally, irrespective of their potential impact on an insurance company's solvency. For example, two of the eight financial analysis elements on which states are scored are reporting of material adverse findings and action on material adverse findings. During the first Tennessee accreditation review in February 2000, reviewers gave the department a score of 4.24 for reporting on material adverse findings (a process-oriented element) and a score of 1.54 for action on material adverse findings (an outcome-oriented element). Thus, the fact that the state took no action on an adverse material finding of fraud—which resulted in theft and a company's failure—carried no more weight than the other elements.

A March 1996 Ernst and Young analysis of the accreditation program (the only independent analysis of the accreditation program requested by NAIC) recommended that the elements of Part B standards be weighted. The report noted that the overall contribution each standard made to regulating financial solvency appeared to vary. For example, according to the report, supervisory review of work papers appeared to Ernst and Young analysts to be a more critical activity than formatting examination reports, even though NAIC accreditation procedures weighted them equally. NAIC's Financial Regulation Standards and Accreditation Committee considered revising the scoring system and weighting the elements of the standards. However, the committee concluded that all of the standards were equally important to an overall financial solvency program and thus decided not to revise the scoring system.

The second scoring methodology weakness involves the averaging of scores for standards within the financial analysis and examination sections. For example, the scores for each of the nine financial examination elements are totaled and a straight average calculated to

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<sup>16</sup>In accordance with NAIC's accreditation procedures, a state must attain a passing score in both the Part A and B Standards (C is not scored). Part A is scored on a Pass/Fail basis. States must have substantially similar authority for each of the Part A standards to be considered in compliance with them. To be in compliance with the Part B Standards, states must attain a passing score in each of the three sections of Part B with a 3.0 or higher average and must also attain a score of at least 1.0 on each of the individual Part B Standards.

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determine the score for the financial examination section. Such an approach allows a “netting” process to take place by allowing an above average score on one element to offset a below average score on another element within the same section. This “netting” feature is particularly critical because the standards themselves are all of equal weight. For example, on the first Tennessee accreditation review in February 2000, a score of 3.88, above that needed for passing, was awarded for the element on scheduling of exams and a 2.60, or below that required overall for passing, for the element on appropriate supervisory review. Thus, the 3.24 straight average of the two scores is above that needed for a passing grade even though one element received a low score. Tennessee’s accreditation was suspended because it failed to pass the financial analysis section portion of the review. However, the failing score was by the slimmest of margins—a 2.98 average, with a 3.0 average needed in order to pass. Thus, above average scores for some elements, including that for “reporting of material adverse findings,” were nearly able to offset below average scores for others, most notably the element for “action on material adverse findings.” To further illustrate how close Tennessee came to passing, in spite of the known problems, three of the five review-team members’ individual scores averaged to a passing score for the entire financial analysis section.

The third area of scoring weakness is the built-in bias toward passing, which comes into play when there is no basis to judge a department’s performance on an element. For example, if none of the companies sampled in a state had an identified adverse material finding during the period under review, then review team members (following NAIC policy for second-round accreditation scoring) assign a score of 4 (out of 5) for both reporting and acting on material adverse findings. This situation occurred in the second Tennessee review, since the review team did not identify any material adverse issues for the companies reviewed in the sample. Such a policy, when used in conjunction with other scoring techniques such as giving equal weight to all elements and averaging scores, makes it easier for a state to attain an overall passing score, even if there are deficiencies in other elements. Some rating systems attempt to reduce this type of bias, either by having a “no basis to judge” category that excludes a standard or element from the scoring, or by assigning a neutral score to minimize the impact on the overall score.

#### Compliance Testing Is Sometimes Cursory Because of Limited On-Site Review

Compliance testing may be cursory because reviewers are allowed only 1 week or less on site, regardless of the size and complexity of the insurance department or the extent of problems that are identified. Moreover, the review is typically performed by 4 or 5 contract staff and an NAIC

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observer, whether the state being reviewed has more than 100 multistate insurers or only a handful. While team members review the self-assessment materials prepared by insurance departments before on-site visits, the parameters on time and resources limit the team's ability to perform in-depth analyses and independently corroborate what the insurance department officials report. According to NAIC, the first day of a review commonly consists of meeting with state insurance department officials and obtaining an overview of the states' financial and examination procedures and resources. In addition, the review team selects a judgmental sample of multistate companies for an in-depth review that begins the afternoon of the first day. The team generally continues reviewing the sample files during the 2nd, 3rd, and sometimes 4th days of the on-site visit, while also interviewing insurance department staff associated with the sampled companies. At the same time, the team reviews the adequacy of the state's organizational and personnel practices—the Part C standards. During the 4th and 5th days, the team must also make time for internal team member discussions of findings, accreditation review scoring, preparing and writing the team report and management letter, and discussing the findings with state insurance department officials. NAIC officials explained that the Tennessee visit in February 2000 lasted 5 days and had a five-member team and one NAIC observer—typical numbers for both the duration and level of resources of on-site visits.

While it may not always be necessary to schedule more than 5 days for an on-site accreditation review, the ability to do so when appropriate would help avoid inadequate compliance testing. Too little compliance testing can have serious consequences for the effectiveness of the review process. During the Mississippi second-round accreditation review, Franklin Protective Life (one of the Mississippi companies that failed owing to losses associated with the \$200 million fraud) was selected for review by the Mississippi accreditation team. By the time the accreditation on-site review took place (in October 2000), it was commonly known that Franklin Protective Life and two other insurance companies domiciled in Mississippi had operated for several years after having been looted of their assets in the fraud. Financial analysts from the Mississippi Insurance Department had failed over a number of years to notice that the company's assets were missing and either failed to notice or failed to take action on other "red flags" that could have led to an earlier identification of the fraud. Nevertheless, the accreditation team leader, after reviewing the financial analysis files for Franklin Protective Life, concluded in the review team's summary notes that "no serious failing in regulatory duties

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and responsibilities was noted in the five year analysis review for this company.”

By way of contrast in terms of depth of review, the Tennessee state auditors spent from July 1999 to July 2000, or about 1 year, analyzing and summarizing their findings.<sup>17</sup> While the objectives and approach of the state auditors and the accreditation review team differed, both efforts were, in part, an attempt to evaluate the performance effectiveness of the Tennessee Department of Commerce and Insurance. The state auditors’ more detailed and comprehensive analysis disclosed a number of serious problems, including the failure to take action on reported material adverse findings—the principal reason Tennessee’s accreditation was suspended in March 2000. The audit report noted the Tennessee Insurance Division’s gross regulatory breakdown in this case, despite significant warning signs of questionable activity. The report also recommended a number of improvements, including additional confirmation procedures for insurance company assets held by custodians, improved documentation, improved supervisory review procedures, longer retention of examination work papers when a troubled insurer is involved, and improved supervisory control over financial analysis checklists. While a year would certainly be too long for an accreditation review, limiting all reviews to a week or less may be too constraining.

We compared the February 2000 accreditation findings in Tennessee with findings disclosed in our prior report on the investment fraud and found a number of weaknesses that were noted in our report but were not identified in the accreditation reviews. In analyzing the review team’s work papers, we found no discussion of weaknesses or concerns that had been identified in areas such as staff investment expertise or failure to detect misappropriation of assets. (See appendix I for a listing of weaknesses identified in our earlier report.)

#### Review Teams Lack Flexibility to Focus on the Most Material Issues

Perhaps the most significant weakness of the accreditation review team process is its limited flexibility. Without flexibility, the examination team is unable to focus on areas known to be of concern or to use the limited

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<sup>17</sup>After the fraud allegedly masterminded by Martin Frankel became public in May 1999, the Tennessee State Auditor performed a compliance review of the Tennessee Insurance Department and issued a report in July 2000 noting that weaknesses existed. These weaknesses included the regulators’ failure to exercise sufficient professional skepticism, inadequate procedures for reviewing an insurance company, and misapplied review procedures.

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review team time to concentrate on material issues. Instead, the team uses exactly the same process and procedures regardless of the prevailing circumstances—even in an environment where fraud is known to have occurred. In spite of the fact that the NAIC accreditation officials and the accreditation team's leader knew about the insurance fraud problems in Tennessee, the review team's work plans were not substantially modified to address what was clearly the most material event existing in the department at that time.

To further illustrate this inflexibility, the Mississippi accreditation work plans were not tailored to address weaknesses in the Mississippi Insurance Department, even though both NAIC and the Mississippi Insurance Department had acknowledged them. While a detailed review of the same issues could be viewed as unfair, we found no evidence that the review team was instructed or attempted to determine what corrective actions were being taken or whether closer scrutiny of certain standards were warranted based on recent material adverse events. The program's inflexibility, which does not allow the review team to focus its limited capacity on material issues, seems counter to the goal of increasing public trust in the solvency regulation process. Moreover, a risk-focused approach would allow the most efficient use of limited review team time and resources.

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#### **Additional Observations About the Accreditation Program**

Our assessment of the accreditation reviews in Tennessee and Mississippi showed that the processes and practices were in accordance with accreditation guidelines and instructions. NAIC also reports that the accreditation reviews conducted in Tennessee and Mississippi were typical of the review processes used in all the accreditation reviews conducted in other states. NAIC officials reported that a total of 99 first- and second-round accreditation reviews were brought before the Financial Regulation Standards and Accreditation Committee between the program's inception and July 26, 2001. A total of two suspensions resulted from these on-site reviews—Tennessee and Washington State—both in

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connection with second-round reviews. Both states were subsequently reaccredited.<sup>18</sup>

We also found two other structural features of the accreditation program that could affect its effectiveness. First, while NAIC advises and provides technical assistance to individual states, it does not oversee or supervise state insurance departments. Thus, any recommendations and suggestions made by NAIC to the states do not have to be accepted. Second, the accreditation assessments are not independent, because NAIC is an association of the heads of the state insurance departments. Specifically, the commissioners are simultaneously the source of the standards, the heads of the entities being evaluated—and the state insurance departments, and the ultimate judges of the departments' success or failure in terms of accreditation. This lack of organizational independence creates inherent impairments that can affect the ability of review teams to do their work and report their findings impartially. For example, states have a "right of refusal" regarding individuals selected for the on-site review team. In addition, while NAIC can choose from a number of contract review team members, it has only four review team leaders. While the experience and continuity provided by this small pool of team leaders might be a plus, there is also the possibility that the leaders could be "co-opted" by the program and its undeniably positive goals.

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## Conclusions

The accreditation program has been evolving since its inception more than 10 years ago. NAIC has taken a number of steps that it believes have strengthened the program. NAIC has reported improvements in a number of areas, including adding standards that suggest best practices for the states; expanding NAIC's reviews of state solvency regulation, which now include analyses of a sample of failed or troubled companies; and increasing the number of states in the program, so that most are now participating. Following the scam allegedly perpetrated by Martin Frankel, NAIC and state insurance regulators in Tennessee and Mississippi as well as other states acknowledged the need to further strengthen insurer solvency regulation. Corrective actions emanating from the insurance fraud have included identifying the appropriate custodial requirements for

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<sup>18</sup>New York, the first state accredited, was subsequently suspended as a result of an interim annual review. The New York State legislature declined to pass two laws that are required for accreditation. In addition, the West Virginia Insurance Department was suspended due to a failure to undergo the on-site review required every 5 years for second-round accreditation.

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insurers' assets, using investment specialists on certain examinations, implementing more proactive communications between states, and establishing a Form A database to help states track the status of change-in-ownership applications that are submitted to other state regulators. We believe these positive steps have been designed to strengthen NAIC's accreditation program in its efforts to strengthen solvency oversight of insurance companies.

NAIC's description of its accreditation program points out that America's insurance consumers need "a system of effective solvency regulation." The accreditation program is intended to certify that accredited states have the baseline authorities, processes, procedures, and resources needed to provide a system to protect consumers not only in those states where insurance companies are domiciled, but also in every state where the companies operate. Clearly, determining whether a state has the laws and regulations necessary for insurance regulators to act is fundamental. Moreover, NAIC has designed its accreditation program so that model laws and regulations can be added to the standards as needed, and a number of such models have been added since the program's inception. The recent fraud in Tennessee, Mississippi, and other states has illuminated another area where NAIC can assist the states. The accreditation program can be improved by developing or revising model laws relative to chartering and changes in the control of insurance companies and adding them to the standards along with associated practices and procedures.

Measuring a state's effective performance of its regulatory responsibilities for solvency may be more difficult than determining whether it has the necessary laws and regulations. However, differentiating an "effective" system of solvency regulation from an ineffective one is an important objective of the accreditation program, particularly since the start of the second round of accreditation reviews. The examiner team instructions for determining compliance with Part B standards (Regulatory Practices and Procedures) require the teams to evaluate not only whether state insurance departments have the necessary laws and regulation on the books, but also whether the departments have implemented them appropriately. The instructions add, "To satisfy the standards set forth in this section, the Department should demonstrate to the review team that they timely identify potentially troubled insurers and institute appropriate courses of action...." This did not occur in Tennessee or Mississippi. As a result, while Tennessee's accreditation was suspended for a short time, the accreditation reviews did not identify many of the regulatory weaknesses that had allowed the affected companies in both states to evade detection

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and operate for several years not only without adequate capital but also without assets. While we recognize the difficulties of detecting deliberate fraud, there is room for the accreditation program to continue improving its mechanisms for assessing the effectiveness of states' regulatory performance in the same way it has expanded the basic set of laws and regulations states are expected to have. Its success in making these improvements will enhance the level of confidence insurance consumers can have in each accredited state's insurance regulatory system. Without these improvements, the accreditation program may not succeed in clearly differentiating between the state insurance departments that can be expected, on the basis of past performance, to effectively regulate the solvency of insurance companies and those departments that may not.

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## Recommendations for Executive Action

We recommend that the Executive Vice President of NAIC

- Strengthen the accreditation program's focus on chartering and change of ownership by
  - developing appropriate model laws, regulations, and procedures for chartering insurance companies;
  - reviewing the current standards and guidelines related to change in ownership and make any necessary changes;
  - including the new and improved model laws and regulations in the accreditation standards and developing companion compliance standards for regulatory practices and procedures; and
  - providing appropriate guidance to the review teams to assure better assessment of a state's performance in these areas of solvency regulation.
- Implement new on-site review team procedures by
  - requiring the inclusion of all relevant exam information since the last accreditation review, and
  - developing a scoring methodology that places more emphasis on standards that directly affect insurance company solvency.
- Ensure that the accreditation program provides the review team with the flexibility to adjust the time and scope of on-site visits as necessary to conduct the level of testing required to address known material issues.

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## Agency Comments and Our Evaluation

We requested and received written comments on a draft of this report from the Executive Vice President, NAIC (see app. III for the complete text of NAIC's letter). In summary, they were pleased to note the positive comments we made about the various improvements and successes since

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the accreditation program's inception. They also appreciated our recommendations for further improvements and stated that they are committed to giving each of them serious consideration.

Regarding our specific recommendations, NAIC generally agreed with our first recommendation concerning the need to strengthen the accreditation program's focus on chartering and change in ownership and noted some specific actions being taken or planned in that regard. Consistent with our second recommendation, NAIC is currently considering changes that would require review teams to consider examinations from earlier in the accreditation cycle. In addition, while NAIC has considered on more than one occasion the concept of weighting accreditation standards, it agreed to again review its scoring system in light of our concerns. Finally, regarding our third recommendation addressing the need to ensure review team flexibility to adjust on-site visits so that appropriate testing can occur, NAIC believed its program had the flexibility to consider known areas of weakness, but agreed to review its procedures in light of our concerns.

In NAIC's more detailed comments (see page 2 of the comment letter in app. III), NAIC stated that not even the best-designed systems can ensure that fraud, intentionally perpetrated upon an insurance company, can be immediately detected. In addition, it believed that a Department's performance on one individual company that was the subject of an alleged fraudulent scheme was not necessarily an accurate indicator of a Department's overall financial solvency program. We agree that it can be difficult to immediately detect fraud, but note that the fraud discussed in this report went undetected for nearly 8 years despite numerous indicators, or red flags—many in documents available to regulators throughout this period. Further, we found no clear indication that the oversight weaknesses contributing to the long-term success of this fraud were unique to a single company. In fact, three of the failed companies were domiciled in Mississippi (although the NAIC review team looked at only one). Moreover, in the aftermath of the failures, both Tennessee and Mississippi acknowledged systemic weaknesses in their regulatory oversight practices that had made them overly vulnerable to the fraudulent activity. Since the fraud was uncovered, Tennessee, Mississippi, and NAIC have begun to implement various corrective actions designed to reduce the possibility of future occurrences. In a similar light, we believe that further corrective actions can be made to NAIC's accreditation program to better ensure its success in evaluating the effectiveness of the states' financial solvency programs.

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## Scope and Methodology

To obtain information on NAIC's efforts to improve its accreditation program, we visited NAIC Headquarters in Kansas City, Missouri, and attended the open portions of the three most recent quarterly meetings of NAIC's Financial Regulation Standards and Accreditation Committee (FRSAC). At NAIC headquarters, we obtained and analyzed relevant documents describing the accreditation program's goals, objectives, scope, and accomplishments, as well as summary statistics. Officials at NAIC also provided us with their view of improvements made to the program since its inception in 1990. We did not independently verify every improvement, nor did we independently review the laws and regulations of individual states to verify their adoption of the NAIC models. At NAIC quarterly meetings, we obtained various documents on accreditation issues and plans and discussed these with FRSAC members as appropriate. In addition, we interviewed key accreditation officials about the program's operations and obtained their view of major accomplishments and improvements.

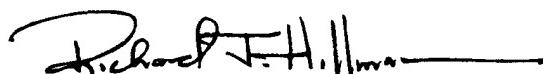
To analyze the accreditation reviews in Tennessee, we visited NAIC headquarters and reviewed all work papers and related reports summarizing the two reviews. We also reviewed the work papers and associated documents from the Mississippi accreditation review. We subsequently discussed these reviews with representatives of both the Tennessee and Mississippi Insurance Departments. We obtained and analyzed various documents pertaining to the goals, objectives, accreditation review procedures, scoring methodology, and criteria. We also interviewed NAIC officials responsible for these reviews and the contractor who functioned as team leader for the on-site visits. In addition, we reviewed an operational study of the accreditation program conducted by Ernst and Young, the only outside analysis of the program requested by NAIC.

We conducted our review in Kansas City, Missouri; Nashville, Tennessee; and Jackson, Mississippi, between December 2000 and July 2001 in accordance with generally accepted government auditing standards. While the findings of this report apply to the accreditation program as a whole, other issues related to NAIC's accreditation program may need to be addressed. Our focus was on the accreditation process in Tennessee and Mississippi during and after the insurance scam allegedly perpetrated by Martin Frankel. Other issues unrelated to the circumstances found in those two states were outside the scope of our review.

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As agreed with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to the Chairman of the House Committee on Energy and Commerce as well as the Chairman and Ranking Member of the House Committee on Financial Services and the Senate Banking, Housing, and Urban Affairs Committee. At that time, we will also send copies of this report to the Executive Vice President of NAIC and to the 55 state and other governmental entities that are members of NAIC and also make copies of the report available to other interested parties upon request.

Sincerely yours,



Richard J. Hillman  
Director, Financial Markets and  
Community Investment

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# Appendix I: Tennessee and Mississippi Received Accreditation During and After Thefts Causing Company Insolvency

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In September 2000, we reported on a \$200 million theft involving insurance company failures in six states.<sup>1</sup> Four of the failed insurance companies were domiciled in Tennessee and Mississippi. In 1994, both Tennessee and Mississippi received their first round accreditation during the theft, which had not yet been discovered. The theft was subsequently discovered in May 1999. Events associated with that discovery led to the delay of the second round accreditation reviews in Tennessee. Tennessee's second round accreditation was suspended in March 2000 and reinstated in September 2000. Mississippi's second round accreditation was granted in December 2000. As discussed below, the Tennessee and Mississippi accreditation events occurred in an environment of long-standing insurance solvency regulatory oversight weaknesses.

In the 1980s, Martin Frankel worked in the securities industry. SEC permanently banned him from the securities industry in 1992. Even prior to his removal from the securities industry, he was setting up the mechanism to move into the insurance industry. He allegedly gained secret control of a small securities firm called Liberty National Securities (LNS), which in 1991, a year before his ban from the securities industry, he directed to become registered with the state securities department in Tennessee. The same year, he allegedly anonymously established an entity known as Thunor Trust, using the names of nominee grantors as the apparent source of the money. Thunor Trust then applied for regulatory approval from the Tennessee Department of Commerce and Insurance, Division of Insurance, to purchase the Franklin American Life Insurance Company, a small, financially weak insurer. This application was subsequently approved. In this and all subsequent interactions with insurers or with regulators, Mr. Frankel's name was never used. He allegedly operated by using aliases or through fronts.

From 1991 to 1999, Thunor Trust purchased six more insurance companies domiciled in five additional states. All of the insurance companies owned by Thunor Trust were managed out of the Franklin American headquarters in Franklin, Tennessee, even though they continued to be domiciled for regulatory purposes in the states of Mississippi, Oklahoma, Missouri, Alabama, and Arkansas. The insurer bought by Thunor Trust in Alabama was later redomesticated (moved) for regulatory purposes to Mississippi, even though it continued to be operated out of Tennessee. Mr. Frankel

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<sup>1</sup>*Insurance Regulation: Scandal Highlights Need for Strengthened Regulatory Oversight* (GAO/GGD-00-198, Sept. 19, 2000).

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allegedly used the same scheme to loot each of the insurance companies. After purchasing a company, Frankel removed the company's assets from the control of the insurance company, using LNS as a front. Shortly after Thunor Trust purchased an insurer, the company's assets would all be sold and apparently replaced with government bonds purchased on the insurer's behalf by LNS, acting under the direction of Mr. Frankel who allegedly operated using an alias. None of this activity involved the real LNS; rather, it was carried out by a bogus LNS operated by Mr. Frankel out of his mansion in Connecticut.

In actuality, the companies lost control of their assets when the money was allegedly turned over to LNS. Mr. Frankel's bogus company, using the name of the firm he secretly controlled—that is, the real LNS—provided monthly statement to each insurance company detailing a very active trading strategy and showing the bonds that were supposedly bought and sold that month by LNS as agent for the insurer. According to these statements, the bond trading was profitable, and the profits were returned to the company. In fact, the securities transactions shown on these statements did not happen. The statements were fabrications. Allegedly, Mr. Frankel actually used the company's assets to (1) return phony profits to the company, (2) purchase additional insurance companies—a necessary step to continue the fraud, and (3) support his own lavish lifestyle. Ultimately, taxpayers, other insurers, and certain policyholders will bear the losses resulting from the scam.

The first round accreditations for Tennessee and Mississippi occurred in September 1994 and December 1994, respectively. After the \$200 million theft became public in May 1999, NAIC delayed its second round accreditation review for Tennessee, scheduled for September 1999, at the request of the Tennessee State Auditors because of their ongoing review of the Tennessee Insurance Department triggered by the theft. In March 2000, Tennessee's accreditation was suspended for failing the financial analysis portion of the review. Six months later, at Tennessee's request, NAIC conducted an additional accreditation review that resulted in reaccreditation of the state in September 2000. NAIC also conducted a reaccreditation review of Mississippi after the \$200 million theft became public, resulting in reaccreditation of Mississippi in December 2000.

Among other weaknesses in state regulatory oversight it exposed, the theft uncovered weaknesses in chartering and change in ownership approvals, a key phase of oversight for preventing undesirable individuals from controlling insurance companies and insurer involvement in questionable business strategies. The theft also showed that financial losses associated

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with risks heightened by such weaknesses in oversight could be material, leading to insurer failures and hundreds of millions of dollars in lost insurer assets. Because the accreditation reviews discussed in this report involved states closely involved with the scandal, an overview of our findings regarding regulatory oversight weaknesses is included in table 1.

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**Table 2: Regulatory Oversight Weaknesses Identified by GAO in Our September 2000 Report**

Oversight phase	Weakness	Specific observations
Change in ownership approvals	Inadequate due diligence performed on buyer application data	<ul style="list-style-type: none"> <li>Failure to act on "red flags" associated with trust managed by a sole and irrevocable trustee that left grantors with no control over money</li> <li>Inadequate questioning of prospective buyers</li> </ul>
	Inadequate tools and procedures to validate individual's regulatory or criminal backgrounds	<ul style="list-style-type: none"> <li>Inability to readily access regulatory history data</li> <li>Inability to access criminal history data on individuals</li> </ul>
Routine financial analyses	Lack of coordination between regulators within and outside the insurance industry	<ul style="list-style-type: none"> <li>Failure to exchange insurance regulatory concerns among states on a timely basis</li> <li>Absence of an industry "clearinghouse" of insurer application data</li> <li>Inability to routinely access data from other financial regulators</li> </ul>
	Inadequate analysis of securities investments	<ul style="list-style-type: none"> <li>Inadequate state procedures and practices to flag high asset turnover ratios and no use of thresholds to trigger additional scrutiny</li> <li>Lack of NAIC policies, procedures, or practices to assess asset turnover</li> <li>Insufficient securities expertise exhibited by insurance departments to question unusual investment strategy</li> <li>Lack of NAIC consolidated financial analysis of affiliated insurers in multiple states</li> </ul>
On-site examinations	Ineffective mechanisms to safeguard and monitor control of insurer's securities held by another entity	<ul style="list-style-type: none"> <li>Inconsistent and ineffective policies regarding appropriate asset custodial relationships</li> <li>Failure of insurance regulators to require from insurers sufficient information to allow independent verification of legitimacy and appropriateness of new custodians</li> <li>Inadequate information collected annually to understand who had control of the insurer's assets</li> </ul>
	Inadequate securities-related expertise and information gathering	<ul style="list-style-type: none"> <li>Lack of expertise to assess the viability of the insurer's investment strategy</li> <li>Failure to obtain securities-related expertise from state securities regulators or from contracted assistance</li> <li>Lack of communication with state securities regulators to verify the appropriateness and legitimacy of the broker-dealer</li> </ul>
Failure to detect misappropriation of assets		<ul style="list-style-type: none"> <li>Failure of four completed exams on companies owned by Thunor Trust to identify any material weaknesses</li> <li>Inadequate examination guidelines and procedures to verify book-entry securities that were not held by a depository institution</li> <li>Inadequate assessment of highly unusual investment activities</li> <li>Questionable ability of insurance examiners to assess securities-related activities</li> </ul>
Inadequate practices and procedures to verify the legitimacy of asset custodians		<ul style="list-style-type: none"> <li>Inadequate efforts to independently validate the identity and appropriateness of the asset custodian</li> <li>Improperly executed custodial agreements not detected</li> </ul>
	Limited sharing of information and coordination among regulators	<ul style="list-style-type: none"> <li>Lack of proactive alerts to warn other states of examination concerns so as to deter scam from spreading</li> <li>Lack of communication with securities regulators</li> <li>Lack of coordinated on-site examinations for insurers in the same group</li> </ul>

Source: GAO analysis of insurance regulatory data.

The report included recommendations to help prevent or detect similar investment scams in insurance companies by proposing the adoption of appropriate asset custody arrangements, improved asset verification

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procedures, and the sharing of confidential regulatory information across industries and agencies. In addition to the above recommendations emanating from the Frankel matter, this report also contained a recommendation designed to broaden and help sustain cooperation among regulators of different financial services sectors.

NAIC and three affected states also conducted parallel reviews of the scam and disclosed similar weaknesses along with recommendations for corrective actions. In July 2001, we provided a status report on corrective actions that NAIC, Tennessee, Mississippi, and Missouri have taken or are taking to address recommendations contained in our September 2000 report to address the regulatory oversight weaknesses.<sup>2</sup>

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<sup>2</sup>*Regulatory Initiatives of the National Association of Insurance Commissioners*, (GAO-01-885R, July 6, 2001).

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# Appendix II: An Overview of the NAIC Accreditation Program

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Although the market for insurance is national in scope, with many companies selling insurance in multiple, if not all, states, the state-by-state system of insurance solvency regulation has traditionally been uneven. Regulatory capacity has varied across states, and laws, regulations, and practices have lacked uniformity. During the 1980s and early 1990s, a number of insurance companies became insolvent, focusing attention on the weaknesses of state insurance regulation and leading to speculation that the federal government would take over regulatory responsibility. In February 1990, Congressman John Dingell released a report entitled "Failed Promises: Insurance Company Insolvencies" that increased speculation about the imminent federal takeover. The National Association of Insurance Commissioners (NAIC), governors, and state legislatures realized that in order to preserve state regulatory authority, something had to be done to address the regulatory inconsistencies. NAIC had previously formed a special committee to address state regulation of insurance companies and devise an accreditation program. In 1989, NAIC formulated the Financial Regulation Standards (Standards) that would form the basis of the accreditation program, and in 1990 it implemented the program itself. Since the program began, the number of accredited states has grown to 47 and the District of Columbia.

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## How the Accreditation Program Works

The accreditation program is designed to make monitoring and regulating the solvency of multistate insurance companies easier by ensuring that states adhere to the NAIC's standards, which establish the basic recommended practices for an effective regulatory department. To be accredited, states must show that they have solvency laws and regulations that protect insurance consumers; effective, efficient financial analysis and examination processes; and appropriate organizational and personnel practices. A team from NAIC examines state insurance departments that are seeking accreditation for compliance with the Standards. NAIC's Financial Regulation Standards and Accreditation Committee (FRSAC), which comprises regulators from across the country, decides whether states are in compliance and provides additional guidance to those that are not.

States must be accredited every 5 years, and NAIC makes annual interim evaluations of Self-Evaluation Guides submitted by the states. The program uses a scoring system that ranges from a low of 0 (unacceptable) to a high of 5 (excellent). Insurance departments are examined for compliance with all three categories of Standards: Part A (laws and

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regulations), Part B (regulatory practices and procedures), and Part C (organizational and personnel practices).

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**Part A: Laws and  
Regulations**

The purpose of this set of standards is to ensure that states have sufficient authority to regulate the solvency of multistate domestic insurers. To meet the requirements of Part A, state legislatures must adopt all of NAIC's 18 model laws (or versions that are substantially similar) and have authorized the state insurance regulators to implement appropriate regulations. The required laws and regulations cover a range of issues as detailed in table 1.

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**Appendix II: An Overview of the NAIC Accreditation Program**

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**Table 3: Accreditation Standards for Laws and Regulations**

<b>Subject area</b>	<b>Description</b>
1. Examination Authority	The Department should have authority to examine companies with complete access to all books and records, including the records of any affiliated companies, and to examine officers, employees, and agents of the company under oath.
2. Capital and Surplus Requirement	The Department should have the ability to require that insurers have and maintain a minimum level of risk based capital and surplus to transact business and the authority to require additional capital and surplus based upon the type, volume and nature of insurance business transacted.
3. NAIC Accounting Practices and Procedures	The Department should require that all companies reporting to the Department file the appropriate NAIC annual statement blank, which should be prepared in accordance with the NAIC's instructions handbook and accounting practices and procedures manual.
4. Corrective Action	State law should authorize the Department to order a company to take necessary corrective action or cease and desist certain practices that, if not corrected, could place the company in a hazardous financial condition.
5. Valuation of Investments	The Department should require that securities owned by insurance companies be valued in accordance with those standards promulgated by NAIC.
6. Holding Company Systems	State law should contain the NAIC Model Insurance Holding Company System Regulatory Act or an act substantially similar, and the Department should have adopted NAIC's model regulation relating to this law.
7. Risk Limitation	State law should prescribe the maximum net amount of risk to be retained by a property and liability company for an individual risk, based upon the company's capital and surplus.
8. Investment Regulations	State statute should require a diversified investment portfolio for all domestic insurers both as to type and issue and include a requirement for liquidity.
9. Liabilities and Reserves	State statute should prescribe minimum standards for the establishment of liabilities and reserves resulting from insurance contracts issued by an insurer.
10. Reinsurance Ceded	State law should contain the NAIC Model Law on Credit for Reinsurance Model Regulation and the Life and Health Reinsurance Agreement Model Regulation or substantially similar laws.
11. CPA Audits	State statute or regulation should contain a requirement for annual audits of domestic insurance companies by independent certified public accountants.
12. Actuarial Opinion	State statute or regulation should contain a requirement for an opinion on reserves and loss and loss adjustment expense reserves by a qualified actuary or specialist on an annual basis for all domestic insurance companies.
13. Receivership	State law should set forth a receivership scheme for the administration, by the insurance commissioner, of insurance companies found to be insolvent, as set forth in NAIC's Insurers Rehabilitation and Liquidation Model Act.
14. Guaranty Funds	State law should provide for a regulatory framework, such as that contained in NAIC's model acts on the subject, to ensure the payment of policyholders' obligations, subject to appropriate restrictions and limitations when a company is deemed insolvent.
15. Filings With NAIC	State statute, regulation or practice should mandate filing of annual and quarterly statements with NAIC.
16. Producer-Controlled Insurers	States should provide evidence of a regulatory framework, such as that contained in NAIC's model act on the subject or similar provisions.
17. Managing General Agents Act	States should provide evidence of a regulatory framework, such as that contained in NAIC's model act on the subject or similar provisions
18. Reinsurance Intermediaries Act	States should provide evidence of a regulatory framework, such as that contained in NAIC's model act on the subject or similar provisions.

Source: Financial Regulation Standards and Accreditation Program, June 2001.

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**Part B: Regulatory Practices and Procedures**

The Part B standards, regulatory practices and procedures, are recommended practices designed to ensure that states have the necessary resources and capabilities to conduct financial analyses and examinations of firms operating within its jurisdiction. The standards cover the three areas considered necessary for effective solvency regulation: financial analysis, financial examinations, and communication with states and procedures for troubled companies (see table 2). To be accredited, states must attain an average score of 3 in both financial analysis and examinations.

**Appendix II: An Overview of the NAIC Accreditation Program**

**Table 4: Accreditation Standards for Regulatory Practices and Procedures**

<b>Subject area</b>	<b>Description</b>
<b>1. Financial Analysis</b>	
(a) Sufficient Qualified Staff and Resources	The Department should have the resources to review effectively, on a periodic basis, the financial condition of all domestic insurers.
(b) Communication of Relevant Information to/From Financial Analysis Staff	The Department should ensure that relevant information and data received by the Department, which could assist in the financial analysis process, is provided to the financial analysis staff, and that findings of the financial analysis staff are communicated to the appropriate person(s).
(c) Appropriate Supervisory Review	The Department's internal financial analysis process should provide for appropriate supervisory review and comment.
(d) Priority-Based Review	The Department's financial analysis procedures should be priority-based to ensure that potential problem companies are reviewed promptly.
(e) Appropriate Depth of Review	The Department's financial analysis procedures should ensure that domestic insurers receive an appropriate level or depth of review commensurate with their financial strength and position.
(f) Documented Analysis Procedures	The Department should have documented financial analysis procedures and/or guidelines to provide for consistency and continuity in the process and to ensure that appropriate analysis procedures are being performed on each domestic insurer.
(g) Reporting of Material Adverse Findings	The Department's procedures should require that all material adverse indications be promptly presented to the commissioner or an appropriate designee for determination and implementation of appropriate regulatory action.
(h) Action on Material Adverse Findings	Upon the reporting of any material adverse findings from the financial analysis staff, the Department should take timely action in response to such findings or adequately demonstrate the determination that no action was required.
<b>2. Financial Examinations</b>	
(a) Sufficient Qualified Staff and Resources	The Department should have the resources to effectively examine all domestic insurers on a periodic basis in a manner commensurate with the financial strength and position of each insurer.
(b) Communication of Relevant Information to/From Examination Staff	The Department should provide relevant information and data received by the Department, which may assist in the examination process, to the examination staff and ensure that findings of the examination staff are communicated to the appropriate person(s).
(c) Use of Specialists	The Department's examination staff should include specialists with appropriate training and/or experience or otherwise have access to available qualified specialists, which will permit the Department to effectively examine any insurer.
(d) Appropriate Supervisory Review	The Department's procedures for examinations should provide for supervisory review of examination workpapers and reports.
(e) Use of Appropriate Guidelines and Procedures	The Department's policies and procedures for the conduct of examinations should generally follow those set forth in NAIC's <i>Examiners Handbook</i> . Appropriate variations in methods and scope should be commensurate with the financial strength and position of the insurer.
(f) Scheduling of Examinations	In scheduling financial examinations, the Department should follow procedures such as those set forth in NAIC's <i>Examiners Handbook</i> that provide for the periodic examination of all domestic companies on a timely basis. This system should accord priority to companies that exhibit adverse financial trends or otherwise demonstrate a need for examination.
(g) Examination Reports	The Department's reports of examination should be prepared in accordance with the format adopted by NAIC and should be sent in a timely fashion to other states in which the insurer transacts business.

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**Appendix II: An Overview of the NAIC Accreditation Program**

<b>Subject area</b>	<b>Description</b>
(h) Reporting of Material Adverse Findings	The Department's procedures should require that all material adverse findings be promptly presented to the commissioner or an appropriate designee for determination and implementation of appropriate regulatory action.
(i) Action on Material Adverse Findings	Upon the reporting of any material adverse findings from the examination staff, the Department should take timely action in response to such findings or adequately demonstrate the determination that no action was required.
<b>3. Communication With States and Procedures for Troubled Companies</b>	
(a) Communication With States	States should allow for the sharing of otherwise confidential information, administrative or judicial orders, or other action with other state regulatory officials providing that those officials are required, under their law, to maintain its confidentiality. This policy should also include cooperation and sharing information with respect to domestic companies subject to delinquency proceedings.
(b) Procedures for Troubled Companies	The Department should generally follow and observe procedures set forth in NAIC's <i>Troubled Insurance Company Handbook</i> .

Source: Financial Regulation Standards and Accreditation Program, June 2001.

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**Part C: Organizational and Personnel Practices**

The Part C standards, organizational and personnel practices, are intended to ensure that the staff of state insurance departments have the appropriate skills and training to promote effective regulatory practices. The standards cover professional development, minimum educational and experience requirements, and personnel retention as detailed in table 5. These standards are not scored; instead, the review team provides comments to the state insurance department officials.

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**Table 5: Accreditation Standards for Organizational and Personnel Practices**

<b>Subject area</b>	<b>Description</b>
1. Professional Development	The Department should have a policy that encourages the professional development of staff involved with financial surveillance and regulation.
2. Minimum Educational and Experience Requirements	The Department should establish minimum educational and experience requirements for all professional employees and contractual staff positions in the financial regulation and surveillance area.
3. Retention of Personnel	The Department should have the ability to attract and retain qualified personnel for those positions involved with financial surveillance and regulation.

Source: Financial Regulation Standards and Accreditation Program, June 2001.

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**How Accreditation Reviews Are Conducted**

States request an accreditation or reaccreditation review by contacting NAIC, which requires them to first fill out a "Self-Evaluation Guide." This guide allows the state to assess itself against the detailed requirements of the Standards. The chair of FRSAC selects a review team of three to six contract examiners and appoints a review team leader. NAIC sends the names of the review team to the state, which can challenge any member. In this case, NAIC and the state negotiate until a new team is selected.

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Once the review team is established, NAIC and the state schedule the visit. Generally, a site visit requires 3 to 5 days, depending on the size of the department. NAIC sends copies of the state's completed Financial Regulation Standards Self-Evaluation Guide, with any applicable supporting documentation, to the review team and tells the state what the team will need for its review. Prior to the on-site review, the state can request an abbreviated review ("pre-review") by an NAIC official in order to learn about any improvements that need to be made.

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**On-Site Review Procedures**

The review team follows a set of procedural guidelines that are designed to make the evaluation process uniform across states. Before the on-site review, team members meet to discuss comments and concerns raised by the Self-Evaluation Guide and supporting documentation. During the on-site review itself, the team examines compliance with laws and regulations; assesses examination reports (usually six), supporting work papers, and interviews; inspects financial analysis and regulatory files for a sample of companies (usually 12); interviews department personnel and reviews organizational and personnel practices; and does a walk-through of the department. Once they have completed these tasks, the team members meet to discuss their findings and vote on a score for whether the state is in compliance with NAIC's accreditation standards addressing regulatory practices and procedures. The team then holds a closing conference with the state and provides a copy of the scores and draft copies of the compliance report and other material, including the management letter addressed to the insurance department. After the site visit, the review team submits its report, a compliance report, and management letter comments to FRSAC. The reports summarize the procedures performed during the site visit, document the findings, highlight major recommendations, and recommends that accreditation be approved or suspended.

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**FRSAC's Evaluation Process**

FRSAC meets quarterly at the NAIC national meetings to discuss the accreditation reviews from the previous 3 months with team leaders, representatives of the states applying for accreditation, and the NAIC observers. FRSAC members will have reviewed the self-evaluation guides and supporting documents from each review, and team leaders present their reports and recommendations. FRSAC may also query the state insurance department representatives. On the basis of the review team's recommendation and the meeting, FRSAC decides whether the state should be accredited, reaccredited, or have its accreditation suspended. If

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suspended, a state can apply for another accreditation review at a later date.

While states must undergo the full review process every 5 years in order to maintain accreditation, they may be subject to a special review if FRSAC receives information suggesting that a state may no longer meet the Standards. FRSAC then determines whether the state's accreditation should be suspended or revoked. The state has the right to appeal the decision.

The annual reviews take place on the anniversary of the initial accreditation. For these reviews, states submit an updated self-evaluation guide. For the first annual review, states must also respond to any recommendations made during the initial accreditation review. NAIC reviews these materials and summarizes them for FRSAC. FRSAC then determines whether the state remains in compliance. The state has the right to appeal a negative decision.

# Appendix III: Comments From the National Association of Insurance Commissioners

**NAIC**  
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

August 27, 2001

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Mr. Richard Hillman  
Associate Director  
US General Accounting Office  
Room 2A28  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Hillman:

We appreciate the opportunity to review and respond to the recent report by the General Accounting Office ("GAO") titled "Insurance Regulation: The NAIC Accreditation Program Can Be Improved."

First, and most importantly, we wish to thank the GAO for its recognition of the fact that the NAIC's Financial Regulation Standards and Accreditation Program (the "program") has been extremely successful in improving the quality of insurance regulation in the United States. As the report points out, even though it has been in existence for just over 10 years, the program has already demonstrated its value by defining a broadly accepted set of regulatory requirements for solvency regulation and in successfully prompting their adoption in nearly all states. The program has improved state insurance regulation in many ways. For example, between 1990 and 2000, state insurance departments increased the number of financial analysts from 165 to 471. State insurance department examination staffs have also increased over this time period. To address the need for on-going training of analysts and examiners, the NAIC has significantly increased the number of training programs offered and in 2000 alone, more than 1900 insurance regulators attended such programs. The program has also added substantial new requirements to the program, increasing the states' authority over areas such as risk-based capital, standard valuation practices, actuarial opinions/memoranda and credit for reinsurance. All of this, and other improvements prompted by the program, have had a dramatic effect on the prevention and detection of insurance company insolvencies. There were fewer than half as many insurance company insolvencies in the years 1993-2000 than in the previous seven-year period.

Although the program has been extremely successful in improving the quality of insurance regulation, we do not contest the GAO's premise, as set forth in the report's subtitle: "The NAIC Accreditation Program Can Be Improved." The NAIC has made numerous improvements to the program since its inception, and continues its efforts to revise and strengthen the program. We appreciate the GAO's recognition of these efforts and the GAO's conclusion that the planned improvements will further enhance the strength of the program.

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In response to the body of the report:

- The focus of the GAO's review of the program centered on the accreditation reviews of the Tennessee and Mississippi Insurance Departments, and extensively upon how those reviews considered the Departments' processes, procedures and actions related to the insurance companies controlled by Martin Frankel. We would re-emphasize that the failure of the companies controlled by Frankel were the result of an alleged fraudulent scheme masterminded by Frankel. Although the NAIC believes the program helps ensure that insurance regulators have strong financial surveillance programs in place, not even the best-designed system can ensure that fraud, intentionally perpetrated upon an insurance company, can be detected immediately.
- The report states that the program largely ignores oversight of chartering and changes in control of insurance companies. While it is true that the program does not currently include standards related to the process of chartering insurance companies, the program does require that states have statutory authority that is substantially similar to that provided in the NAIC's Insurance Holding Company System Regulatory Act. Central to this act is the required filing of the Form A, Statement Regarding the Acquisition of Control of or Merger With a Domestic Insurer, which requires all potential changes of control to be reported to and approved by the commissioner of the domiciliary state of the target insurance company. The accreditation review teams are required to determine if states are generally implementing the requirements of the Part A, Law and Regulation, Standards as part of the on-site review process, thus helping to ensure that the required laws are in fact being administered. It should also be noted that although the program does not currently contain standards related to chartering of insurance companies, each of the 50 states and the District of Columbia have laws, regulations, administrative procedures and processes in place for the evaluation of new charters.
- The report states that the program has no standards addressing the identification of material adverse findings, only standards relating to the reporting of, and action upon, material adverse findings. With the exception of Reporting and Action on Material Adverse Findings Standards, all of the Part B standards are specifically designed to address the identification of material adverse findings. A department's failure to detect a material adverse finding would be assessed in connection with each of these standards. The report also fails to recognize that the scoring of the standards is based upon the Department's performance in the surveillance of each of the companies selected by the review team. We do not believe that a Department's performance on one individual company that was the subject of an alleged fraudulent scheme is necessarily an accurate indicator of a Department's overall financial solvency program.

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- The report states that the scoring system utilized by the NAIC contains certain weaknesses, including giving equal weight to each of the Part B standards, averaging or "netting" the scores within each of the subparts of Part B, and, an inherent scoring bias towards passing. The NAIC has, on more than one occasion, considered the concept of weighting the Part B standards and has determined that weighting of the standards is unnecessary and potentially counter-productive. In designing the program, an effort was made to only include standards that address issues that have a significant effect on solvency regulation. The relative importance of the individual standards changes depending on the circumstances. In addition, the NAIC does not wish to encourage states to focus their efforts on certain areas that might be assigned more weight in the scoring process, and thus give short shift to other areas with a high potential solvency impact. The "less critical" standards, as alluded to by the report, are also more comprehensive than what might be generally understood. For example, the report references an earlier report of Ernst & Young which makes the comparison between standards purportedly pertaining to "the supervisory review of workpapers" and "the formatting of examination reports" and concluded that these standards should not be given equal weight. However, the standard regarding examination reports deals with much more than formatting, and includes items such as whether the reports properly describe the examination findings, whether the reports are prepared and issued in a timely fashion and whether the reports are mailed to other states in which the insurance company does business. Obviously, an excellent supervisory review of examination workpapers would be undermined if the examination findings are never finalized or if the report is issued so late that the findings are moot. Additionally, a state's inability to attain a high score on any one standard does not accurately reflect that state's overall abilities related to analysis and examinations. However, to help ensure that states do not simply ignore a standard and its requirements, the NAIC has implemented a minimum score that must be attained on each Part B Standard.
- In reference to an inherent scoring bias towards passing, the report uses the action and reporting of material adverse findings standards as an example of a state automatically receiving a high score if the review team discovers no material adverse findings in the sample of companies selected, thus elevating the average score of the subpart. However, to obtain the high score noted in the report, the state must also have processes and procedures in place to properly report, and take action upon, material adverse findings.
- The report states that on-site reviews are limited to one week regardless of the size and complexity of the insurance department or the extent of the problems identified. While it is true that the length of the on-site reviews is generally one week, the amount of actual compliance testing performed varies significantly from department to department. For example, for a recent accreditation review, the review team did extensive work prior to the commencement of the on-site visit, including meeting for three days prior to the on-site review to assess

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compliance with the standards. This was in addition to the one-week on-site review that occurred the following week. Also, it is not unusual for the total hours worked by the review team to vary significantly based on the size and complexity of the insurance department.

- The report states that the accreditation review teams are unable to alter the scope of the review due to the limited flexibility of the program. The report cites the failure of the Mississippi review team to alter the scope of the review to address acknowledged weaknesses. While it is true that the review team did not alter the review to address the chartering of Franklin Protective Life (as chartering of insurers is not a part of the accreditation requirements), the team did select the Franklin Protective Company as part of its sample of companies and did assess the Department's analysis and examination procedures regarding this company. This demonstrates that the review teams have the flexibility to consider known areas of weakness.

In its report, the GAO has recommended additional changes in three areas. In response to the recommendations:

- The GAO has recommended that the accreditation program should increase its focus on the processes used by insurance regulators during the initial licensure (chartering) of insurance companies and during the review of proposed changes of control. We agree with this recommendation, and we are already in the process of developing a nationwide database, adopting forms and checklists and making other changes that will assist regulators in these areas. Once these projects are finalized, we will review the accreditation standards to determine how to strengthen the program in these areas.
- The GAO recommended changes to the on-site accreditation review team procedures in two areas.
  - The GAO recommended that the accreditation review teams consider all examinations performed during the entire period since the last accreditation review rather than reviewing only more recent examinations. We are currently considering changes to the Preamble of the Review Team Guidelines that would require the review teams to consider examinations from earlier in the accreditation cycle as part of the sample of companies selected.
  - The GAO made several recommendations regarding the current scoring system. The NAIC has already considered these issues, and no decision has been made as to whether to make additional changes to the scoring system. However, we understand and appreciate the GAO's recommendations, and we will again review the scoring system in light of the GAO's comments.

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- The GAO recommended that the accreditation review teams have greater flexibility to adjust the time and scope of on-site visits, as necessary, to conduct the level of testing required to address known material issues. As stated earlier, we believe that this level of flexibility already exists in the program. However, we understand the GAO's concern in this area, and we will review our procedures in light of the GAO's comments.

Again, we thank you for the opportunity to review and comment on the report. We are pleased that the GAO has recognized the success of the program, and we appreciate the GAO's positive comments regarding the improvements we have already made and those that are underway. We also appreciate the GAO's recommendations for further improvements to the program, and are committed to giving each of them serious consideration as we continue our efforts to further improve the quality of state insurance regulation in the United States.

Sincerely,



Catherine J. Weatherford  
NAIC Executive Vice President

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# Appendix IV: GAO Contacts and Staff Acknowledgments

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## GAO Contacts

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## Acknowledgements

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